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No. 711

IN THE

Supreme Court of the United States

October Term 1961

AARON M. NADLER,

Petitioner,

v.

SECURITIES AND EXCHANGE COMMISSION, ET AL.

ON PETITION FOR WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR PETITIONER

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The SEC cannot pass this case off as involving merely a routine affirmance by the Court of Appeals of an administrative order of the Commission. The proceedings and order of the SEC on which the Court below relied were a nullity insofar as any binding effect on petitioner or that Court was concerned.

The real question presented by this case is whether the SEC can block a public investor's right to have a violation of the Act tried by the courts and prevent an independent judicial determination of the legality of an order granted by it in error.

This case starts with an admitted and flagrant violation of Section 16(a) of the Act, when an entire board of directors was put in office by the illegal and outlawed device of *seriatim* resignations. Their first act was to loot and cripple the investment company by turning over half its assets to those who put them in office.

As soon as these facts were discovered a suit was brought in the District Court by a public investor to enforce the violation of the Act and void the illegal transaction.

Unfortunately, the SEC had been an unwitting participant in the illegal scheme by permitting the disqualified directors to jam through the SEC, without a hearing, and on nine days constructive notice by second class mail during the Christmas holidays, an exemption of the transaction from other prohibitions of the Act.

The SEC staff should have caught the violation of the Act but by error didn't. Had it known of the violation, or that the transaction was not at arms-length, the Commission would never have granted its order on an *ex parte* presentation and without notice to, and an opportunity to be heard by, the common stockholders.

But with the mistake uncovered and a suit pending in the District Court, the SEC did not join in that suit or await a judicial determination of the violation of the Act by the forum vested with exclusive jurisdiction of the matter.

Instead, the SEC usurped the jurisdiction and function of the District Court and, on its own motion, instituted its own proceeding to try the identical questions there pending. The record of that proceeding reveals an astounding attempt to justify at all costs the SEC's mistake. The trial examiner repeatedly held that the original order could not be attacked by the public investors unless they first proved actual fraud in obtaining the order in addition to the violation of the Act. The Commission adopted that same position in its Findings and Opinion (Pet. App. 45, 46, 47).

This absurd and unfounded legal pronouncement, placing an impossible burden of proof on the outside public investor as against the law-breaking fiduciary, effectively blocked the presentation or consideration of any case by the public stockholders.

The SEC then discontinued its proceedings. They had served the purpose of permitting the SEC to review the legality of its own order and try the violation of the Act before the questions could be tried by a court of competent jurisdiction. Unless those proceedings were a nullity, they would bar the suit in the District Court under the doctrine of *res adjudicata* or they would be binding on the Court as an administrative determination

In view of the strategy pursued by the SEC, petitioner had no choice but to ask the Court of Appeals to declare the SEC proceedings a nullity and not binding on him. Petitioner at the same time, in order to remove the illegal exemption order as a bar to the District Court suit, asked the Court of Appeals to enjoin or set aside the SEC's original order as procured by the invalid acts of illegal directors which petitioner had elected to void.

Instead of making an independent judicial determination of the legal questions raised by petitioner, the Court of Appeals affirmed the SEC order discontinuing its proceedings and held the Commission's Findings and Opinion to be conclusive against petitioner. In effect, the Court of

Appeals held that the public investor has no right to have the courts pass on the legality of an SEC order or try a violation of the Act, if the SEC does not acquiesce.

A basic question presented to this Court is whether the Court of Appeals erred in the legal status and effect it ascribed to the SEC proceeding.

The SEC proceedings were a nullity insofar as having any binding effect on petitioner or the Court of Appeals. The SEC order was merely an exercise of its executive discretion not to prosecute and as such could not be affirmed by the Court of Appeals. It was not an act of judicial discretion because the SEC is completely without jurisdiction to try a violation of the Act.

1. *Reply To The Argument That The SEC Had Discretion.* The claim that the SEC has discretion with respect to a violation of the Act has a deceptively valid ring to it. It falls apart completely once the obvious and necessary distinction is made between executive-discretion and judicial-discretion.

Nobody disputes that the SEC has executive-discretion to decide for itself what action it will take on an alleged violation of the Act. It can go into court to enforce it, or refrain from doing so on any grounds it sees fit, including the belief that no violation exists. These are the familiar prerogatives of any prosecutor or enforcement agency.

But such executive-discretionary decisions are binding on no one except the SEC. In *Goldstein v. Groesbeck*, 142 F. 2d 422 (2 Cir., 1944) cert. denied 323 U. S. 737, it was held that an agreement made by the SEC not to enforce a violation of the Public Utility Holding Company Act of 1935 did not bar a suit under the Act by a private stockholder on the same violation.

By discontinuing the proceedings which it had itself initiated to look into the matter, the SEC did no more than exercise its executive discretion to take no action on a violation which it deemed excusable. Such an order because it is so clearly an exercise of executive discretion is not binding as an administrative-judicial determination or

even reviewable by the courts as such. It is clearly comparable to the Commission's order in *SEC* v. *Louisiana Public Service Comm.*, 353 U. S. 368, where under the Public Utility Holding Company Act the SEC by order declined to reopen a prior proceeding. This Court there held that type of order not subject to judicial review by the Court of Appeals.

2. *Reply To The Argument That The SEC Had Jurisdiction.* It is elementary that a court or administrative body must have jurisdiction in order to make its decree or order binding on third parties.

The SEC has absolutely no power or jurisdiction to try a violation of the Act, to make a binding determination of whether or not there was a violation, its effect if any, or to enforce it. That jurisdiction is exclusively vested in the courts by Section 44 of the Act (Pet. App. 62).

Unlike other Acts administered by the SEC, Congress in the Investment Company Act of 1940 gave the SEC no power of administrative-judicial enforcement. The only enforcement of the Act is through the courts. The SEC under this Act cannot in an administrative-judicial hearing find a violation of the Act and issue a stop order or a cease and desist order, which would be given the effect of an administrative determination by the courts. The SEC must go into the courts as a litigant alleging a violation of the Act, and that issue is tried independently by the courts. Under the legislative scheme of this Act, the SEC's role is limited to the granting of exemptions from the Act.

The SEC had no jurisdiction to try a violation of the Act without a proceeding for an exemption order. Its attempted usurpation of the jurisdiction and function of the District Court was not binding on petitioner and the Court of Appeals erred in making the SEC proceeding conclusive as to petitioner's rights.

3. *Reply To The Argument That The SEC "In Effect" Granted A Retroactive Exemption Order From The Violation Of Section 16(a).* Realizing that the SEC has no jurisdiction to try a violation of the Act, and that its statu-

tory power is limited to the granting of exemptions, the argument is now made that the SEC "in effect" granted a retroactive exemption or that its action was "consistent" with that power.

The short answer to this proposition is that no SEC order exempting the violation of Section 16(a) exists or was ever granted. The speculation that the Commission might have done so is fully disposed of by the fact that it did not.

Not only was no such order in fact granted, but the SEC in its brief to the Court of Appeals thrice expressly denied that it had made such an order directly or by implication.

> "Petitioner erroneously believes that the Commission, in deciding not to revoke the prior order, has granted an exemption from Section 16(a)." (SEC Brief to Ct. App. p. 16)
>
> "An examination of the facts makes it apparent that an exemption was not granted." (SEC Brief to Ct. App. p. 17)
>
> "Consequently, the determination not to revoke the prior order was based on these considerations and not because of an exemption from Section 16(a) granted by the Commission." (SEC Brief to Ct. App. p. 17)

Moreover, Section 6(c) of the Act (SEC Brief p. 11), upon which reliance is placed for this power of the SEC to grant an exemption order, permits the SEC to grant exemptions on its own motion only by general rules and regulations. To grant a specific exemption by order, Section 6(c) requires that an application be made to the Commission. Other requisites of such an order are notice of the application to the interested parties, a hearing on the merits, an order granting the exemption and finally an opportunity for an appeal therefrom to the courts. Not one of these prerequisites exist in this case.

Petitioner cannot be deprived of his rights under the Act and his day in court by a non-existent exemption order.

4. *Reply To The Argument That The Illegal Acts Of The Directors Are Not Void But Only Voidable Under Section 16(a) Of The Act.* "Void" or "voidable" is an exercise in semantics and makes no particle of difference in this case. Even a void act stands as valid until someone elects to void it.

All parties before this Court agree that the illegal acts were at least voidable. The real question in the case is "Who could elect to void them?"

The Court of Appeals held that only the SEC could elect to void the illegal acts. Petitioner contends that a public stockholder has an equal and independent right to elect to void the illegal acts. This is the heart of the question presented to this Court.

A public stockholder, for whose benefit the Act was enacted, had elected to void the illegal acts and brought a suit in the District Court to do so before,—we repeat, before—any action was taken by the SEC on the violation of Section 16(a).

The Court of Appeals erred in not holding the illegal acts voidable at the election of a public stockholder, and in refusing to make an independent judicial determination of the legal questions presented by petitioner.

5. *Reply To The Argument That The Stipulation In The District Court Bars Petitioner From Relief.* The action in the District Court is still pending and has not been dismissed. The injunction of that Court preserving the status quo is still in effect.

Contrary to the statement on page 12 of the SEC brief, petitioner did not stipulate to the dismissal of the District Court action if the Court of Appeals affirmed the SEC order. The stipulation is effective only upon the final disposition of this case and that will not be until this Court has spoken.

The stipulation is totally irrelevant to the issues here presented. It was entered into in good faith recognizing that the same legal questions were presented by the petition to the Court of Appeals as were presented in the

District Court action. The Court of Appeals will not pass on the same case twice and its declaration of the law is binding on the United States District Court for the Southern District of New York.

It is the decision of the Court of Appeals that will bar any further action in the District Court, not the stipulation. The truth and validity of that contention can readily be tested by reading the Court of Appeals' opinion and then considering whether petitioner could prevail in a District Court action on the same violation, absent any stipulation.

6. *Reply To Certain Misstatements Of The Record.*

a) The SEC brief at page 4 makes the statement that reports had been filed by the new owners. While reports were filed by the three new directors, no reports were filed by the other purchasers since the stock had been split up in such a way as to give each holder less than 10% of the class and thereby circumvent the reporting requirements of the Act. For instance, the fact that the wife of the Executive Vice-President of Dynamics was one of the purchasers under her maiden name was a well kept secret until the last days of the hearing.

b) The SEC brief at page 5 states that petitioner knew of the original application before the order was issued but did not request a hearing. The fact is that petitioner in New York heard a rumor that there was such an application on December 28th, the same day that time to request a hearing expired in Washington, D. C. at 2 P. M. Petitioner promptly applied to Dynamics and SCG for information but first received any concrete knowledge of the proceeding when he was shown a copy of the SEC order on December 31st, the day the transaction was consummated (Pet. App. 40; Rec. in Ct. App. 1379-1386).

c) The SEC brief at pages 7 and 12 refers to the fact that petitioner brought the violation of the Act to the attention of the SEC and invited it to take action. The SEC fails to add that this invitation was not accepted.

It was only when petitioner advised the SEC that he intended to bring the District Court action, and after he did so on April 1, 1960, that the SEC took action to initiate its own proceeding on April 12, 1960.

d) The SEC states at page 7 of its brief that petitioner had a full hearing on the reasonableness and fairness of the transactions. The record of the proceeding before the trial examiner and the SEC's own Findings and Opinion belie this conclusively (Pet. App. 45-47). The SEC repeatedly stated that it would not and did not reconsider the fairness and reasonableness of the transactions, since in its view petitioner first had to prove actual fraud in addition to a violation of the Act. The Commission went so far as to deny a motion of its own staff to take additional evidence on the merits because it believed it irrelevant under its decision (Pet. App. 49). The length of the hearing or the record has little meaning if petitioner's evidence is excluded from consideration.

e). The SEC states at page 12 of its brief that petitioner consented to a stay of the District Court action pending the hearing by the Commission and seeks to interpret that as an agreement to litigate the matter before the Commission. The consent to the stay was no such agreement. The SEC fails to state that on the hearing petitioner promptly and vigorously objected to a trial of the violation by the SEC and its usurpation of the jurisdiction and function of the District Court (Rec. in Ct. App. 363-422; 436-438; 513; 529). The trial examiner overruled petitioner's objections, which were renewed by petitioner in his brief and argument and again overruled by the Commission. Moreover, the SEC seems to forget that lack of jurisdiction cannot be cured by consent.

CONCLUSION

Brook v. *Managed Funds, Inc.*, 286 F. 2d 901 (8 Cir., 1961), certiorari granted, 366 U. S. 958, presented the question of whether a public stockholder has any independent rights under the Act. This case presents the same question with the equally important added question of whether the public stockholder can be deprived of those rights by the SEC.

For the foregoing reasons, certiorari should be granted to review the decree of the Court below.

Respectfully submitted,

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